

Message Text

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ACTION EUR-08

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FM AMEMBASSY LISBON

TO SECSTATE WASHDC IMMEDIATE 8494

INFO AMEMBASSY BONN

USMISSION EEC BRUSSELS

C O N F I D E N T I A L SECTION 1 OF 2 LISBON 6223

LIMDIS

DEPT PASS TREASURY

E.O. 11652: GDS

TAGS: EAID, PO

SUBJECT: GOP REQUEST FOR LOANS

REF: (A) LISBON 6070 (DTG 041325Z SEP 76),

(B) LISBON 6203 (DTG 101344Z SEP 76)

1. ACCOMPANIED BY ECON COUNSELOR I MET AGAIN LAST NIGHT, SEPT 10, WITH MARIO SOARES TO DISCUSS FURTHER THE POSSIBILITY FOR A LOAN TO PORTUGAL ALONG LINES REFTEL A.

2. SOARES CALLED ATTENTION TO HIS SPEECH THE PREVIOUS NIGHT (REF B) AS EVIDENCE OF THE GOVERNMENT'S SERIOUS INTENT TO MOVE FORWARD WITH AN EFFECTIVE ECONOMIC PROGRAM. I NOTED SPEECH HAD ADDRESSED THE ISSUE OF LABOR PRODUCTIVITY AT SOME LENGTH AND IN A VERY COURAGEOUS WAY, BUT IT DID NOT GO INTO ANY DEPTH ON SUCH QUESTIONS AS INTEREST RATES AND DEVALUATION. COMMENTING ON LATTER POINT SOARES
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POINTED TO A PASSAGE SAYING PORTUGAL WOULD "DEFEND

THE ESCUDEO." HE TOLD US THIS WORDING WAS DELIBERATELY AMBIGUOUS. FINANCE MINISTRY WOULD SHORTLY BE ISSUING A STATEMENT THAT THERE WOULD BE NO DEVALUATION. THIS APPROACH WAS DESIGNED TO AVOID UNDERMINING PM'S CREDIBILITY WITH THE GENERAL PUBLIC IF A DECISION IS MADE TO DEVALUE. SUCH A DECISION, SOARES SAID, WOULD OBVIOUSLY HAVE TO BE IMPLEMENTED THE SAME DAY IT IS MADE.

3. SOARES SAID THE DEVALUATION ISSUE CONTINUED TO BE DEBATED WITHIN THE COUNCIL OF MINISTERS. THERE WERE STRONG ARGUMENTS IN FAVOR OF IMMEDIATE DEVALUATION. MANY OF THESE HAD BEEN PRESENTED BY THE MIT TEAM; BUT A NUMBER OF PORTUGUESE ECONOMISTS WERE STRONGLY OPPOSED TO DEVALUATION. THIS OPPOSITION RESTS HEAVILY UPON FEARS THAT DEVALUATION WOULD SPARK A SHARP RISE IN THE INFLATION RATE, A TREND WHICH GOP WOULD BE ILL PREPARED TO CONTROL. POLITICAL REACTION TO UNCONTROLLED INFLATION WOULD BE STRONGLY NEGATIVE. WE SHOULD NOT FORGET THAT PORTUGAL HAD LIVED 50 YEARS UNDER SALAZAR, WHO HAD TAUGHT THE PEOPLE THAT THE COUNTRY'S MOST IMPORTANT ASSET WAS THE SOUNDNESS OF THE ESCUDO.

4. I TOLD SOARES I HADNOT RECEIVED A FORMAL RESPONSE FROM WASHINGTON TO HIS REQUEST. HOWEVER, THE INFORMAL REACTION I HAD WAS THAT SYMPATHY EXISTED FOR A SHORT-TERM LOAN OF 300 MILLION DOLLARS, DEPENDING ON OUR ANALYSIS OF THE GOVERNMENT'S PROGRAM. THE LARGER LOAN OF ONE BILLION WAS MORE COMPLEX, AND SHOULD BE DEALT WITH AS A SEPARATE ISSUE. IT WAS CLEARLY TOO LARGE AN OBLIGATION FOR THE USG TO ASSUME. HENCE RECOURSE WOULD HAVE TO BE MADE TO A MULTILATERAL FORUM. SOARES AGREED COMPLETELY. THE SHORT-TERM LOAN, HE SAID, WAS DESIGNED TO GIVE THE GOVERNMENT A BREATHING SPACE, BUT THE KEY TO THE DEVELOPMENT PROGRAM WAS THE LARGER LOAN, WHICH WOULD ENABLE THE GOVERNMENT TO PLAN FOR THE LONGER TERM. THE TWO

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WERE CONCEPTUALLY DIFFERENT AND SHOULD BE TREATED AS SEPARATE ISSUES. HE DID NOT EXPECT THE USG TO MAKE THE LARGER LOAN SINGLE-HANDLY, BUT HE WOULD APPRECIATE OUR HELP PUTTING TOGETHER A CONSORTIUM WHICH MIGHT INCLUDE GOVERNMENTS, INTERNATIONAL INSTITUTIONS AND THE PRIVATE SECTOR.

4. SOARES UNDERSCORED THE POLITICAL IMPORTANCE

OF EARLY ACTION. HIS SPEECH HAD BEEN INTERPRETED
CORRECTLY BY THE PCP AS A DECLARATION OF WAR.
HE INTENDS TO SEPARATE THE PCP LEADERSHIP FROM ITS
SUPPORTERS BY CUTTING OFF ITS SUPPLY OF MONEY.
THE MAIN SOURCE OF FUNDS FOR THE PCP WAS NOT MOSCOW
AS MOST PEOPLE THOUGHT, BUT THE GOP THROUGH
SUCH HOLES IN THE BUDGET AS THE AGRICULTURE
REFORM PROGRAM AND SPECIAL FUNDS FOR EDUCATION
AND SPORTS. THE PCP KNEW IT HAD ITS BACK TO THE
WALL AND INTENDED TO FIGHT BITTERLY. THE GOVERNMENT
NEEDED TO MUSTER ALL ITS RESOURCES FOR THE STRUGGLE
AHEAD. HE WOULD MAKE THE HARD DECISIONS ON THE
ECONOMY, BUT URGENTLY NEEDED THE SUPPORT AND
FLEXIBILITY THAT EXTERNAL FINANCE WOULD AFFORD.

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5. COMMENT: WITH HIS THURSDAY NIGHT SPEECH
SOARES HAD, IF NOTHING ELSE, CONVEYED TO THE COUNTRY A
SERIOUSNESS OF PURPOSE. THIS SAME SENSE OF PURPOSE HAS
BEEN EVIDENT IN HIS CONVERSATIONS WITH ME. LAST
NIGHT HE CALLED OUR ATTENTION TO HOW FAR PORTUGAL
HAS MOVED TOWARD STABILITY, BUT NOTED SOBERLY
THAT IT STILL HAD A LONG WAY TO GO.

6. WE ALREADY HAVE INDICATIONS FROM BANK OF PORTUGAL THAT INTEREST RATES WILL BE RAISED SUBSTANTIALLY. AS BEST WE CAN TELL THE PREPONDERANCE OF ADVICE SOARES IS RECEIVING FAVORS EARLY DEVALUATION. WHILE HE HAS AVOIDED A COMMITMENT IN HIS CONVERSATIONS WITH ME, HIS COMMENTS SUGGEST THAT HE IS RECEPTIVE TO THAT ADVICE. HIS REFUSAL PUBLICLY TO DENY DEVALUATION SEEMS TO US TO BE SIGNIFICANT.

7. THE POLITICAL CASE FOR OUR SUPPORT AT THIS JUNCTURE SEEMS TO ME TO BE OVERWHELMING. SOARES IS THE MAN PRINCIPALLY RESPONSIBLE FOR PULLING PORTUGAL BACK FROM THE BRINK OF COMMUNISM; HIS
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GOVERNMENT IS COURAGEOUSLY PURSUING A STRONG PRO-WESTERN POLICY WITH A "EUROPEAN OPTION." HE HAS LAUNCHED AN OFFENSIVE AGAINST THE PCP, AND IS MOVING GRADUALLY TO RESTORE A SENSE OF DISCIPLINE IN THE ECONOMY. THE PCP REACTION TO HIS SPEECH WAS RAPID AND VIOLENT. WE MIGHT PREFER FROM A STRICTLY ECONOMIC STANDPOINT THAT SOME OF HIS MOVES BE MORE DRAMATIC AND MORE RAPID, BUT WE MUST CONTINUE TO BEAR IN MIND THAT THE COMMUNISTS HOLD MOST OF THE TRUMPS IN ORGANIZED LABOR. SOARES MUST LAUNCH A POLITICAL OFFENSIVE ON THE LABOR AREA AT THE SAME TIME AS HE IMPOSES ECONOMIC AUSTERITY, A NEAT TRICK FOR A MINORITY GOVERNMENT. HIS CHANCES OF SUCCESS DEPEND VERY MUCH ON THE FINANCIAL MANEUVERABILITY WE AND OTHERS CAN GIVE HIM.

8. AT SOARES INITIATIVE, ECONOMIC COUNSELOR AND I WILL HAVE FURTHER DISCUSSIONS ON MONDAY SEPT 13, WITH THE MINISTER OF FINANCE AND CENTRAL BANK GOVERNOR SILVA LOPES. WE WILL PURSUE WITH THEM QUESTION OF INTEREST RATES AND DEVALUATION. IF WE RECEIVE POSITIVE INDICATIONS IN THESE TWO AREAS, WE PRESUME BASIC GOP ECONOMIC POLICY CONDITIONS FOR 300 MILLION DOLLAR LOAN WILL HAVE BEEN ESTABLISHED.
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